



MEMORANDUM

To: Members of the Investment Committee
California Public Employees' Retirement System


Date: December 13, 2010

From: Pension Consulting Alliance, Inc. (PCA)

RE: Real Estate Performance through September 30, 2010

PCA has received and reviewed Wilshire's Third Quarter 2010 Executive Summary of CalPERS' Investment Performance as it relates to the Real Estate Portfolio. The following items should be considered in your assessment of Real Estate's performance:

- In an illiquid asset class populated with multi-year partnerships, longer term results are more significant than those of a shorter duration. Over all periods under consideration the CalPERS total real estate performance has underperformed the Policy Index. **This has been primarily driven by the vintage 2006-2007 investments' poor performance in the real estate portfolio and, therefore, the short-term results continue to warrant close scrutiny.**
- The total Real Estate Portfolio produced a -1.0% return during the quarter and a -10.8% return over the trailing year compared to the Policy Index returns of 5.3% and 2.3%, respectively.
- The Public REITs, which represent approximately 7.8% of the market value of the Real Estate Portfolio, had a strong quarter turning in an 18.4% return, and a 16.6% return over the trailing one-year.
- The Core Portfolio continued to underperform due to the large exposure to non-core assets. The Core Portfolio was reappraised as of March 31, 2010 and had value erosion particularly in the Apartment and Industrial programs, where there is exposure to non-core assets. The March 31, 2010 appraisals captured the impact of eroding fundamentals on income and appreciation, leverage levels, and capital market valuation declines.
- The Opportunistic Portfolio turned in a -4.5% return for the current quarter due to valuation declines primarily in the Urban program.
- The performance in the real estate portfolio has been influenced by four primary factors. First, capital markets have had significant impact on real estate property valuations. Second, macro-economic factors have had a deleterious effect on rents and net



operating income. The final two factors are related to the exposure in the CalPERS real estate portfolio to non-stabilized assets with higher amounts of leverage. These final two factors have exacerbated the recent underperformance to the benchmark as non-stabilized assets provide less income to insulate valuation declines and increased leverage magnifies returns in upward and downward market cycles.

- The market value of the Real Estate Portfolio as of September 30, 2010 was \$15.3 billion, which represents an increase of \$1.7 billion or 12% from last year (September 30, 2009). The overall increase in value in the Real Estate Portfolio is attributable primarily to new equity that has been funded for deleveraging assets.
- As of September 30, 2010 the real estate asset class represented 7.1% of the total CalPERS portfolio, below the target allocation of 10.0%.
- The under allocation to real estate should give Staff the flexibility to take advantage of potential opportunities that may present themselves due to the distress in the real estate market.
- The partnership review process initiated by Staff to evaluate the risks and merits of individual investments and investment managers is nearing completion. Information gathered through this review process has yielded important lessons learned and is proving very valuable to the restructuring of the portfolio.
- Staff has been active in exiting less desirable partnerships and transferring assets to new partners that have undergone a review and received strong support from Staff and consultants to manage these assets with the best interests of CalPERS in the future.
- The Loan-To-Value (LTV) policy limit is no longer in breach for the total portfolio with a 56% LTV; however, the Core Portfolio is still out of compliance. Staff continues to implement a deleveraging plan that addresses loan-to-value (LTV) considerations, recourse debt limits, and existing, prospective and potential covenant breaches and defaults. These efforts are expected to stabilize the portfolio and relieve Staff from the intense asset-level management responsibilities that have accompanied the distressed debt situations that pervade the portfolio.